

No. 12,811

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA,

Appellant,

vs.

PAUL W. SAMPSELL, Trustee in Bankruptcy of the Estate
of Juvenile Products of Pasadena, a corporation, Bank-
rupt,

Appellee.

Appeal from the United States District Court for the
for the Southern District of California.

BRIEF FOR THE UNITED STATES.

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TOPICAL INDEX

	PAGE
Opinions below	1
Jurisdiction	1
Questions presented	3
Statutes and regulations involved.....	3
Statement	4
Statement of points to be urged.....	9
Summary of argument.....	10
Argument	13

I.

The record establishes that at all times after the estate came under the custody and control of the court, both in the Arrangement and bankruptcy proceedings, the estate assets were adequate to create a trust to cover the amount of the withholding taxes deducted from wages paid to its employees 13

II.

A bankruptcy court, as a court of equity, will require the administration of an estate under its control to proceed in accordance with the congressional mandate and direct, in trust for the United States, the segregation of estate assets sufficient to pay the withholding taxes deducted and the distribution to the United States, as trust beneficiary, of the amount of the trust fund so segregated..... 15

A. The mandate of Section 3661 of the Internal Revenue Code required the court officers administering the instant estate under the control of the bankruptcy court to hold in trust for the United States and pay to the United States the amount of taxes withheld..... 17

	PAGE
B. The estate funds have without interruption at all times since the filing of the petition for an Arrangement remained under the control of the bankruptcy court through its officers.....	20
C. No question of tracing trust property is involved, since the bankruptcy court, as a court of equity, will direct its officers in administering this estate, in its judicial custody and under its control, to comply with equitable obligations imposed by law.....	23
III.	
In any event, the trust fund can here be traced into the bankrupt estate	30
Conclusion	22

INDEX TO APPENDIX

	PAGE
Bankruptcy Act, Chap. 541, 30 Stats. 544:	
Section 342 (11 U. S. C., 1946 Ed., Sec. 742).....	1
Section 343 (11 U. S. C., 1946 Ed., Sec. 743).....	1
Section 1401 (26 U. S. C., 1946 Ed., Sec. 1401).....	1
Section 1622 (26 U. S. C., 1946 Ed., Sec. 1622).....	2
Section 3661 (26 U. S. C., 1946 Ed., Sec. 3661).....	2
Treasury Regulations 106, Section 402.304.....	3
Treasury Regulations 116, Section 405.301.....	4

TABLE OF AUTHORITIES CITED

CASES	PAGE
City of New York v. Rassner, 127 F. 2d 703.....	
.....16, 20, 22, 23, 24, 25, 27, 28, 29, 30	
Frank, In re, 25 Fed. Supp. 1005.....	23
Garrison v. Edward Brown & Sons, 25 Cal. 2d 473.....	31
Goldberger, In re, 32 Fed. Supp. 615.....	30
Grasso v. Oehmann, 75 Wash. Law Rep. 827, 54 A. 2d 570.....	19
Hood v. Hardesty, 94 F. 2d 26; cert. den., 303 U. S. 661.....	26
Independent Automobile Forwarding Corp., In re, 118 F. 2d 537; reversed sub. nom. United States v. New York, 315 U. S. 510.....	23
Kenney & Greenwood, In re, 23 F. 2d 681.....	27
McKee v. Paradise, 299 U. S. 119.....	30
New Bedford Rest., In re, 40 Fed. Supp. 288.....	23
Pepper v. Litton, 308 U. S. 295.....	24
Scully v. Pacific States Savings & Loan Co., 88 F. 2d 384; cert. den., 301 U. S. 704.....	32
Shipe v. Consumers' Service Co., 28 F. 2d 53.....	27
Simmonds, Ex parte, 16 Q. B. D. 308.....	25
Standard Oil Co. v. Hawkins, 74 Fed. 395.....	25
United States v. Fogarty, 164 F. 2d 26.....	20

STATUTES

Bankruptcy Act of 1898, Chap. 541, 30 Stats. 544:	
Secs. 301-399 (11 U. S. C., 1946 Ed., Secs. 701-799).....	20
Sec. 302 (11 U. S. C., 1946 Ed., Sec. 702).....	22
Sec. 311 (11 U. S. C., 1946 Ed., Sec. 711).....	20
Sec. 313 (11 U. S. C., 1946 Ed., Sec. 713).....	20
Sec. 314 (11 U. S. C., 1946 Ed., Sec. 714).....	20
Sec. 322 (11 U. S. C., 1946 Ed., Sec. 722).....	2, 21, 22
Sec. 332 (11 U. S. C., 1946 Ed., Sec. 732).....	20

iv.

	PAGE
Sec. 336 (11 U. S. C., 1946 Ed., Sec. 736).....	20
Sec. 341 (11 U. S. C., 1946 Ed., Sec. 741).....	20
Sec. 342 (11 U. S. C., 1946 Ed., Sec. 742).....	21
Sec. 343 (11 U. S. C., 1946 Ed., Sec. 743).....	21
Sec. 368 (11 U. S. C., 1946 Ed., Sec. 768).....	21
Sec. 369 (11 U. S. C., 1946 Ed., Sec. 769).....	21
Sec. 377 (11 U. S. C., 1946 Ed., Sec. 777)	2, 21
Sec. 378 (11 U. S. C., 1946 Ed., Sec. 778).....	22

Internal Revenue Code :

Sec. 35 (26 U. S. C., 1946 Ed., Sec. 35).....	19
Sec. 1400 (26 U. S. C., 1946 Ed., Sec. 1400)	6, 19
Sec. 1401 (26 U. S. C., 1946 Ed., Sec. 1401).....	20
Sec. 1430 (26 U. S. C., 1946 Ed., Sec. 1430).....	28
Sec. 1622 (26 U. S. C., 1946 Ed., Sec. 1622).....	20
Sec. 1627 (26 U. S. C., 1946 Ed., Sec. 1627).....	28
Sec. 2707 (26 U. S. C., 1946 Ed., Sec. 2707).....	28
Sec. 3661 (26 U. S. C., 1946 Ed., Sec. 3661).....	
.....	3, 9, 10, 11, 12, 17, 24, 28, 30
Revenue Act of 1934, Chap. 277, 48 Stats. 680, Sec. 607.....	17

MISCELLANEOUS

House Conference Rep. No. 1385, 73d Cong., 2d Sess., p. 32 (1939-1 Cum. Bull. (Part 2) 627, 639-640).....	18
Senate Report No. 558, 73d Cong., 2d Sess., p. 53 (1939-1 Cum. Bull. (Part 2) 586, 626).....	17
Treasury Regulations 106, Sec. 402.304.....	19, 28
Treasury Regulations 116:	
Sec. 405.301	19, 28
Sec. 405.401	19

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BRIEF FOR THE UNITED STATES.

Opinions Below.

The only opinion rendered by the District Court is contained in its unreported order on review of the order of the Referee in Bankruptcy. [R. 79-80.] The only opinion rendered by the Referee in Bankruptcy is contained in his certificate to the District Court on the petition to review his order [R. 37-41] and is likewise unreported.

Jurisdiction.

This proceeding arose in the District Court for the Southern District of California, upon a petition for an arrangement under Chapter XI of the Bankruptcy Act, as amended, by Juvenile Products of Pasadena, a California corporation, with its principal place of business at

Pasadena, California [R. 3-8], which was filed on April 6, 1948. [R. 21.] An order approving the petition as one for relief under Section 322 of the Bankruptcy Act, and referring the matter to Benno M. Brink, one of the referees in bankruptcy, was entered on the same date. [R. 21-22.] Jurisdiction of the court below is conferred by Section 2 of the Bankruptcy Act, as amended, and Section 24, Nineteenth of the Judicial Code. Under date of July 24, 1948, the Referee in Bankruptcy entered an order confirming the arrangement of the debtor under Chapter XI of the Bankruptcy Act, as amended. [R. 25-35.] Thereafter, under date of December 13, 1948, the Referee entered an order under the provisions of Section 377(2) of Chapter XI of the Bankruptcy Act, adjudging the debtor, Juvenile Products of Pasadena, a bankrupt, and that bankruptcy be proceeded with pursuant to the provisions of the Bankruptcy Act. [R. 36.] Under date of March 3, 1950, the Referee entered an order which allowed the claim of the Collector of Internal Revenue in the amount of \$1,757.82 as a result of the bankrupt's operation under the provisions of Chapter XI, and as a claim to participate ratably with other claims arising under Chapter XI operation of the debtor, but denied the claim of the Collector of Internal Revenue any priority whatsoever over any other claims arising in or out of the operation of the debtor under Chapter XI. [R. 46-51.] Following an extension of time from March 13, 1950, to and including April 17, 1950, granted therefor by the Referee [R. 52-53], a petition for review of the order of the Referee entered March 3, 1950, was duly filed by the United States on April 17, 1950. [R. 53-61.] On September 30, 1950, the District Court made an order on review of the Referee's order of March 3, 1950, con-

firming the Referee's order, which order of the District Court was filed on October 2, 1950. [R. 79-80.] Notice of appeal from this order of the District Court was duly filed by the United States on October 27, 1950, pursuant to Section 25(a) of the Bankruptcy Act, as amended. [R. 81-82.] Jurisdiction of this court to hear and determine this appeal is conferred by Section 24(a) of the Bankruptcy Act, as amended, and 28 U. S. C., Section 1291.

Questions Presented.

1. Whether the assets of the estate, continuously after the filing of the Arrangement Petition, were adequate to create a trust to cover the amount of the disputed taxes withheld, even though not in cash funds.

2. Whether a bankruptcy court, as a court of equity, will require the administration of an estate under its control to comply with Section 3661 of the Internal Revenue Code and accordingly direct its court officers to segregate, in trust for the United States, estate assets sufficient to pay withholding taxes deducted from wages and distribute to the United States as trust beneficiary the amount of the trust fund so segregated, making further tracing of a trust fund unnecessary.

3. Whether, in any event, the trust fund can here be traced into the bankrupt estate.

Statutes and Regulations Involved.

The pertinent provisions of the Bankruptcy Act, Internal Revenue Code and Treasury Regulations are printed in the Appendix, *infra*.

Statement.

This is an appeal by the United States [R. 81] from an order of the District Court [R. 79-80], confirming an order of the Referee in Bankruptcy. In his order, so far as pertinent, the Referee in Bankruptcy had passed upon a claim by the Collector of Internal Revenue for withholding taxes amounting to \$1,757.82, which had arisen in the course of the bankrupt's operations, as debtor in possession under an Arrangement Proceeding (Chap. XI of the Bankruptcy Act) and while within jurisdiction of the District Court. [R. 48-49.] The Referee's order denied any priority to this claim of the Collector over any other claims arising in the course of the bankrupt's operations as debtor in possession, though allowing the Collector's claim as a claim to participate ratably with other claims arising out of the bankrupt's operations under the Arrangement Proceeding as debtor in possession. [R. 50-51.]

On April 6, 1948, Juvenile Products of Pasadena, a California corporation—as debtor—filed in the court below a petition in proceedings for an Arrangement, pursuant to Chapter XI, Section 322 of the Bankruptcy Act as amended. [R. 3-21, 37.] On the same day the court below approved this petition and made a general order of reference to Benno M. Brink, one of the referees in bankruptcy. [R. 21-22.]

On July 24, 1948, the Referee made an order confirming the proposed Arrangement under Chapter XI [R. 25-35], which provided, among others: that the debtor, Juvenile Products of Pasadena, be continued in possession and authorized to manage, operate and conduct the business of debtor and employ, discharge and fix the compensation of its employees (with certain specified exceptions),

all according to law and subject to such supervision and control by the court as the court might exercise by future orders [par. 2, R. 28-29], that the court retained full jurisdiction over the debtor and its property [par. 9, R. 34, 37-38]; that the debtor was to pay pre-existing federal taxes in specified instalments, and as debtor in possession, to pay taxes during the life of the Arrangement as they became due [par. 7, R. 31-33]; and that [R. 32-33]:

the priorities with respect thereto shall not be affected by the confirmation of Debtor's arrangement but shall remain unimpaired until the taxes shall have been fully paid or satisfied; that the United States of America is hereby granted the same remedies against the Debtor, during the life of its arrangement, and against its assets, with regard to the collection of such taxes, as it had against the Debtor theretofore; * * * that subject to its approval the Court shall retain jurisdiction over the assets herein dealt with and over any and all persons, firms, or corporations to which said assets may be transferred, and over all parties appearing herein for the purpose of carrying out and giving effect to any and all provisions of said arrangement and this order of confirmation insofar as said arrangement affects and applies to tax claims of the United States of America, or for the practical protection of the tax claims of the United States upon subsequent orders pertinent to, in amplification, extension, limitation, or in otherwise modification of this order of confirmation.

The debtor in possession carried on the business under the Arrangement Plan at a heavy loss [R. 39-40], and on December 13, 1948, an order was entered terminating the Arrangement Proceedings under Chapter XI and adjudicating the debtor a bankrupt and directing that

bankruptcy be proceeded with [R. 36, 38.] Appellee herein, Paul W. Sampsell, was appointed trustee in bankruptcy [R. 41] and directed to liquidate the estate. [R. 63.]

As the Bankruptcy Referee subsequently certified to the District Court [R. 38]:

In its said operations [as debtor in possession under the Arrangement Proceeding] the bankrupt deducted withholding taxes from wages and salaries paid by it to its employees. In due course the Collector of Internal Revenue filed herein his claim for \$1,757.82, being the amount of the said taxes which were deducted, as aforesaid.

The taxes thus deducted were in collection of income taxes at the source on wages (Int. Rev. Code, Sec. 1622), and social security taxes (Federal Insurance Contribution taxes, Int. Rev. Code, Sec. 1400). [R. 79.]

On December 16, 1949, upon petition of the trustee in bankruptcy, an order was issued requiring the Collector of Internal Revenue to show cause why his claim for \$1,757.82 should not be paid ratably with the other obligations incurred by the bankrupt during its operations as debtor in possession under the Arrangement Proceeding and prior to its adjudication. [R. 38.]¹

The trustee's order to show cause was duly heard and on March 3, 1950, the Referee filed his findings of fact and order, in which, while allowing the Collector's claim

¹Other matters, included in the trustee's petition, are not raised on this appeal. *i.e.*, the validity of the Collector's claim for a lien based on certain taxes, not here in issue, against the proceeds of certain real property in the hands of the trustee. [R. 38, 42.]

as a claim to participate ratably with the other claims incurred by the bankrupt during his operations as a debtor in possession prior to bankruptcy adjudication, he denied the claim any priority whatsoever over any of the other claims which arose in or out of such operations. [R. 38-39, 50-51.] The facts, which the Referee found as the basis for this order, were that the sum of \$1,757.82 was due and owing as withholding tax arising out of the bankrupt corporation's operation under the Arrangement Proceeding "and while within the jurisdiction of this Court" [R. 48-49], and that [R. 49]:

when wages were paid by this bankrupt corporation during its operation under Chapter XI, the requirements that withholding taxes be withheld and placed in a trust fund were ignored, that is to say, the net amount—*i. e.*, the gross amount of wages, less the amount of withholding tax—was at all times paid; the Court further finds that during the said operation under Chapter XI, this bankrupt corporation at no time had the funds to create or did it create a separate trust fund composed of that portion of the wages withheld for the payment of withholding taxes.

Thereafter, by petition filed with the Referee on April 17, 1950, the United States applied for review by the District Court of the Referee's order of March 3, 1950, denying the Collector's claim priority over the other claims in the operation of the Chapter XI proceeding. [R. 53-60.] Upon this application for review the Referee issued his certificate to the District Court [R. 37-41], in which he summarized the evidence as follows [R. 39-40]:

The bankrupt carried on its Chapter XI operations at a heavy loss. During such operations it did not acquire any new property. On the contrary, the

assets it had at the commencement of the said operations were substantially reduced thereby.

The bankrupt, in its operations as debtor in possession, deducted withholding taxes from the wages and salaries of its employees but it did not at any time create a special fund for any of the amounts so deducted. Furthermore, it did not at any time during the said operations have the funds necessary to create such a special fund. In other words, the bankrupt simply deducted the taxes here in question. It did not set apart the necessary funds to pay the same and it could not have done so at any time during the said operations.

No trust fund for the payment of withholding taxes was taken over by the trustee in bankruptcy in this case.

The assets in the hands of the trustee are insufficient to pay in full the obligations incurred by the bankrupt in its Chapter XI operations.

The Referee, on May 19, 1950, filed his certificate on this petition for review with the District Court [R. 37-41], followed on June 6, 1950, by a supplemental certificate which transmitted additional papers. [R. 61-62.]

From these papers, it appears that receipts of the estate upon liquidation by the bankruptcy trustee of its real and personal property amounted to at least \$46,737.77 [R. 65; Ex. "A," R. 66], and that after payment of a dividend amounting to \$2,108.74 [R. 69], and a number of liquidation disbursements, the trustee reported a cash balance in the estate on October 6, 1949, of \$17,742.95. [R. 70.]

By its order dated September 30, 1950, the District Court entered its order on review, confirming the Referee's order of March 3, 1950. [R. 79-80.] It is from this order of the District Court, so far as it denies priority to the Collector of Internal Revenue in the amount of \$1,757.82 for federal withholding taxes over other claims arising out of bankrupt's operations as debtor in possession under court appointment in the Arrangement proceeding, that the United States takes the instant appeal to this court. [R. 81.]

Statement of Points to Be Urged.

The District Court erred [R. 82-84]:

1. In confirming the Referee in Bankruptcy's order of March 3, 1950.
2. In failing to hold that all of the assets of the debtor, Juvenile Products of Pasadena, a corporation, which the trustee in bankruptcy received were constructively impressed with the trust provided by Section 3661 of the Internal Revenue Code for withholding taxes withheld from wages paid by the debtor while operating under the jurisdiction of the District Court in a Chapter XI proceeding immediately prior to its adjudication as a bankrupt.
3. In confirming the order of the Referee in Bankruptcy of March 3, 1950, and thereby holding that the claim presented by the Collector of Internal Revenue in the

amount of \$1,757.82 covering federal withholding taxes withheld by the bankrupt from the wages paid its employees while the bankrupt was operating under the provisions of Chapter XI of the Bankruptcy Act must participate ratably with other claims arising under the Chapter XI operations of the debtor preceding its adjudication as a bankrupt.

4. In confirming the Referee in Bankruptcy in the latter's failure to hold that the bankrupt during the time it operated under Chapter XI of the Bankruptcy Act had the funds with which to create the trust required by Section 3661 of the Internal Revenue Code with respect to taxes withheld from the wages of its employees.

Summary of Argument.

1. In failing to recognize the adequacy of the estate at all times to satisfy the legal and equitable interest of the United States in its assets, the Referee and the court below demonstrably erred. Clearly, assets far exceeding the amount of taxes due the United States were in court custody continuously from the date of the petition in the Arrangement Proceeding through bankruptcy and came into the hands of the bankruptcy trustee. Inferably, the finding of the Bankruptcy Referee, that the debtor in possession during its operations in the Arrangement Proceeding did not have the "funds" necessary to cover the withholding taxes, must refer merely to "cash funds," but this is immaterial since the record establishes that there were at all times adequate assets in the estate to cover

the claim of the United States as equitable owner or beneficiary of a trust fund in the sum of \$1,757.82.

2. The bankruptcy court, as a court of equity, must recognize and carry out any trust obligation or relationship imposed by law on assets which it is in the process of administering. The debtor in possession, as well as the bankruptcy trustee, was an officer of the court. On settled principles and on authority a court of equity controlling the estate under both officers will see to it that the succeeding bankruptcy trustee carries out such trust obligations as the preceding officer, the debtor in possession, may have failed during its incumbency to have fulfilled. The mandate of Section 3661 of the Internal Revenue Code required the court officers administering the instant estate under judicial control to hold in trust for the United States and pay to the United States the amount of taxes withheld. The instant case is to be differentiated from one where the trust obligation and relationship arose prior to bankruptcy. The estate funds here, without interruption in relationship, at all times since the filing of a petition for an Arrangement remained under the control of the bankruptcy court through its officers. No question of tracing trust property is involved, since the bankruptcy court, as a court of equity, will direct its officers in administering, as an entity, this estate in its judicial custody and under its control to comply with the equitable obligations imposed by law. Equity regards that as done which ought to be done. Hence, the court below should have directed an amount out of estate assets in its custody,

equivalent to the amount withheld from wages by the debtor in possession, to be paid over to the Government. As between administration creditors and the United States, the equities are balanced in favor of the United States. The sanction of severe penalties ordinarily is available to insure compliance with the provisions of Section 3661, but here the status of the debtor in possession under court control would be a defense. To hold the debtor in possession failed to segregate the funds is to hold the court of equity failed to do so and there is no sanction against the court. Even if the debtor in possession and its officers do not possess complete criminal immunity, surely the court will not countenance administration of funds under its control to be carried on in such a manner as to involve violation of penal laws by a court officer.

3. If this court does not agree with the contention advanced, *supra*, it is additionally argued that the amount withheld can here be shown to have augmented and be traced into the bankrupt estate. The real estate and chattels, for example, the proceeds of which the record demonstrates are in the bankruptcy trustee's possession, formed part of the estate at the time the fiduciary obligation arose under Section 3661 and have at all times remained in the estate. Despite estate losses during operations by the debtor in possession, the lowest intermediate amount was never less than the sum due the United States. Under such circumstances the burden falls upon the appellee to show dissipation of the equitable interest belonging to the United States.

ARGUMENT.

I.

The Record Establishes That at All Times After the Estate Came Under the Custody and Control of the Court, Both in the Arrangement and Bankruptcy Proceedings, the Estate Assets Were Adequate to Create a Trust to Cover the Amount of the Withholding Taxes Deducted From Wages Paid to Its Employees.

The Referee found that in its operations under the Chapter XI proceeding, the bankrupt deducted withholding taxes from wages and salaries paid by it to its employees [R. 38] that is, the gross amount of wages, less the amount of withholding tax, was at all times paid. [R. 49.] The Referee further found that the debtor corporation at no time had the “funds” to create a separate trust fund composed of that portion of the wages withheld for the payment of taxes [R. 49], and that it could not have set apart “the necessary funds” at any time during its operations as debtor in possession. [R. 40.]

On the other hand, the record establishes that the estate possessed ample assets adequate to cover and pay the withholding taxes deducted in the maximum amount of \$1,757.82. [R. 38.] Thus, at the time the Chapter XI petition was filed, the debtor corporation swore to ownership of real estate valued in the sum of \$61,986.12, and machinery, fixtures and tools in the sum of \$15,071.59. [R. 10.] After the period of operation by the debtor in possession had concluded—during which period the disputed taxes were withheld—the trustee in bankruptcy reported to the Referee that the bankrupt estate possessed personal property appraised in the amount of \$4,650 [R. 63], and real property sold to the City of Pasadena for

\$36,000. [R. 64.] Indeed, the total receipts of the estate upon liquidation of its real and personal property, as reported by the bankruptcy trustee to the court, amount to at least \$46,737.77. [R. 65; Ex. "A," R. 66.] Moreover, on June 15, 1949, a first dividend in the amount of \$2,108.74 was paid. [R. 69.] After the payment of this dividend and a number of disbursements incident to liquidation, the record discloses a cash balance on October 6, 1949, according to the trustee's report to the court, in the amount of \$17,742.95. [R. 70.]

Inferably the finding of the Referee that the debtor in possession during its operations in the Arrangement Proceeding did not have the "funds" necessary to cover the withholding taxes must refer to "cash funds." Certainly, the record discloses that despite asserted losses incurred during the operations by the debtor in possession in the Arrangement Proceeding, the trustee at their conclusion received assets exceeding in amount many times the sum of \$1,757.82 deducted in those operations for withholding taxes. Again, for reasons discussed in the succeeding points, it is, as a matter of law, irrelevant, whether or not the estate possessed cash assets sufficient to cover this sum of \$1,757.82. Suffice it that the assets of the estate were at all times amply adequate to cover the claim of the United States as equitable owner or beneficiary of a trust fund in that sum. Clearly, assets far exceeding that amount were received by the trustee in bankruptcy at the end of the Arrangement operations and were at all times in the custody of the court under Chapter XI Proceedings or in bankruptcy. In failing to recognize the adequacy of the estate at all times to satisfy the legal and equitable interest of the United States in its assets, the Referee and the court below demonstrably erred.

II.

A Bankruptcy Court, as a Court of Equity, Will Require the Administration of an Estate Under Its Control to Proceed in Accordance With the Congressional Mandate and Direct, in Trust for the United States, the Segregation of Estate Assets Sufficient to Pay the Withholding Taxes Deducted and the Distribution to the United States, as Trust Beneficiary, of the Amount of the Trust Fund so Segregated.

When a court of equity proceeds with the operation or liquidation of an estate, to do equity, it must recognize and carry out any trust obligation or relationship imposed or required to be imposed by statute or otherwise on the assets, which it is in the process of administering. Here, as discussed below, the debtor in possession under the Arrangement Proceeding continued operation of the business, as an officer of the bankruptcy court. When the debtor in possession was displaced by the bankruptcy trustee, there was no break in the continuity of relationship for the order of adjudication related back and the date of the original petition for an Arrangement remained the vital date. Both continued under the control of the court, which in the last analysis administers the bankrupt estate, whether under Chapter XI or in bankruptcy, and the statutory duty, imposed upon the debtor in possession, to create a trust and pay over the trust funds to the United States, is equally imposed on the trustee in bankruptcy, who stands in the shoes of the debtor in possession. A

court of equity controlling the estate *under both officers* will see to it that the succeeding bankruptcy trustee will carry out such trust obligations as the preceding officer, the debtor in possession, may have failed during its incumbency to have fulfilled.

So the Court of Appeals for the Second Circuit in a case substantially on all fours with the instant case has ruled. In *City of New York v. Rassner*, 127 F. 2d 703, involving a New York City sales tax, the local statute made a vendor a "trustee," when collecting the sales tax from vendees. There, as here, a debtor in possession under an Arrangement under Chapter XI of the Bankruptcy Act conducted the business until it was adjudicated a bankrupt. During its operation in the Arrangement Proceeding, the debtor in possession, as here, failed to segregate the taxes. The city asserted that, by virtue of its status as a trust beneficiary, its claim for taxes collected during the administration of the business by a court officer under court control was for direct restitution from any funds of the estate and thus came ahead even of expenses of the administration. On the other hand, the bankruptcy trustee maintained that the city's claim was only on a parity with the claims of administration creditors generally to a fund insufficient to satisfy all such claims. Reversing the Bankruptcy Referee and the District Court, Judge Clark, writing for a unanimous court, sustained the city's claim for full payment ahead of claims of administration creditors, holding that it is the duty of a bankruptcy court in distributing an estate to do so equitably, and protection of a beneficiary of a trust whose funds have been misappropriated is a proper part of equitable administration.

A. The Mandate of Section 3661 of the Internal Revenue Code Required the Court Officers Administering the Instant Estate Under the Control of the Bankruptcy Court to Hold in Trust for the United States and Pay to the United States the Amount of Taxes Withheld.

Section 3661 of the Internal Revenue Code (Appendix, *infra*), reads as follows:

SEC. 3661. ENFORCEMENT OF LIABILITY FOR TAXES COLLECTED.

Whenever any person is required to collect or withhold any internal-revenue tax from any other person and to pay such tax over to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.

Its legislative history is illuminating. The provision, expressed in identical language, originated in Section 607 of the Revenue Act of 1934, c. 277, 48 Stat. 680. The Senate Committee Report in connection with the 1934 Act, recommending enactment of this language (there denoted as Section 606) read as follows (S. Rep. No. 558, 73d Cong., 2d Sess., p. 53 (1939-1 Cum. Bull. (Part 2), 586, 626)):

Existing law provides with respect to a number of taxes that the amount of the tax shall be collected or withheld from the person primarily liable by another person, who is required to return and pay to the Government the amount of the taxes so collected or withheld by him. This is true, for example, in the

case of the taxes on admissions, checks, and telephone and telegraph services. Under existing law the liability of the person collecting and withholding the taxes to pay over the amount is merely a debt, and he can not be treated as a trustee or proceeded against by distraint. Section 606 of the bill as reported *impresses the amount of taxes withheld* or collected *with a trust* and makes applicable for the enforcement of the Government's claim the administrative provisions for assessment and collection of taxes. (Italics supplied.)

The Conference Report confirmed this purpose, as follows (H. Conference Rep. No. 1385, 73d Cong., 2d Sess., p. 32 (1939-1 Cum. Bull. (Part 2) 627, 639-640)):

This amendment impresses taxes collected or withheld with a trust in favor of the United States and makes applicable for the enforcement of the Government's claim the administrative provisions applying to the assessment, collection, and payment of taxes. There is no comparable provision in the House bill. The house recedes with an amendment changing the section number. (Italics supplied.)

Accordingly, it seems clear that Congress intended to impress taxes withheld immediately with a trust in favor of the United States. Thus, instantly such an equitable obligation arose immediately the debtor in possession deducted these taxes, as indisputably the debtor deducted them here.

The Treasury Regulations confirm the trust character of the tax withheld. Thus, Regulations 116, relating to

the collection of income tax at source on wages, Section 405.301, so far as pertinent reads (Appendix, *infra*):

The amount of any tax withheld and collected by the employer is a special fund in trust for the United States.

The same is true under Regulations 106 (Appendix, *infra*) relating to employees' tax and the employers' tax under the Federal Insurance Contributions Act. Its Section 402.304, so far as relevant, reads:

Any employees' tax collected by or on behalf of an employer is a special fund in trust for the United States. * * *

Indeed, the withholding of the amount of these taxes from the employees' salary effects an immediate change of position so far as the Treasury is concerned. Thus (Treasury Regulations 116, *supra*, Section 405.401):

If the tax has actually been withheld at the source, credit or refund shall be made to the recipient of the income *even though such tax has not been paid over to the Government by the employer.* * * * (Italics supplied.)

See to the same effect, Internal Revenue Code, Section 35, as amended by Section 3, Current Tax Payment Act of 1943, c. 120, 57 Stat. 126, and Treasury Regulations 106, *supra*, Section 402.304; and the holding of the Municipal Court of Appeals for the District of Columbia in *Grasso v. Oehmann*, 75 Wash. Law Rep. 827, 54 A. 2d 570.

For an informative description of the statutory pattern, under which the employment taxes under Sections 1400

and 1401 (Appendix, *infra*), and the withholding taxes under Section 1622(a) (Appendix, *infra*), of the Internal Revenue Code are imposed, see *United States v. Fogarty*, 164 F. 2d 26, 28-29, 32-33 (C. A. 8th).

B. The Estate Funds Have Without Interruption at All Times Since the Filing of the Petition for an Arrangement Remained Under the Control of the Bankruptcy Court Through Its Officers.

The instant case is to be differentiated from one where the trust obligation and relationship arose prior to bankruptcy. Here, as the *Rassner* case (pp. 705-706) points out, the equitable obligation and interest arose after the estate came under court control and as an incident to the operation of the estate by a court of equity.

Arrangement proceedings are derived from Chapter XI of the Bankruptcy Act, as added by the Act of June 22, 1938, c. 575, 52 Stat. 840, Sections 301-399 (11 U. S. C. 1946 ed., Sections 701-799). Upon the filing of an Arrangement petition and submission of a plan by the debtor the court has "exclusive jurisdiction of the debtor and his property, wherever located." Section 311. Among its powers over the debtor and his creditors are (Section 313) the right to authorize the debtor to reject or make various types of contracts; (Section 314) to stay suits against the debtor; (Section 332) to appoint a receiver or trustee; (Section 336) to hold meetings of creditors, adjudicate claims, examine the debtor, settle the arrangement plan and in general, exercise the same powers as if (Section 341)—

a decree of adjudication had been entered at the time the petition under this chapter was filed.

Where, as instantly, no receiver or trustee is appointed (Section 342, Appendix, *infra*)—

the debtor shall continue in possession of his property [sic] and shall have all the title and exercise all the power of a trustee appointed under this Act, subject, however, at all times to the control of the court and to such limitations, restrictions, terms, and conditions as the court may from time to time prescribe. (Italics supplied.)

Under Section 343 (Appendix, *infra*)—

the debtor in possession, shall have the power, upon authorization by and subject to the control of the court, to operate the business and manage the property of the debtor during such period, limited or indefinite, as the court may from time to time fix, and during such operation or management shall file reports thereof with the court at such intervals as the court may designate. (Italics supplied.)

The court shall retain jurisdiction, if so provided in the Arrangement (Section 368), and shall in any event retain jurisdiction until the final allowance or disallowance of all debts affected by the Arrangement (Section 369). In the instant case, as appears from the Statement, *supra*, the court below expressly retained full jurisdiction of the Arrangement. [R. 28-29, 32-33, 34, 38.]

Moreover, where (as here) the court has retained jurisdiction after confirmation of an Arrangement and the debtor defaults, the court is authorized where the petition has been filed (as here) under Section 322 of the Act, to enter an order adjudging the debtor a bankrupt and directing that bankruptcy be proceeded with. [Bankruptcy Act, Section 377(2), R. 36.] Upon entry of an order

directing that bankruptcy be proceeded with in the case of a petition for an Arrangement originally filed (as here) under Section 322 of the Act, the proceeding is to be conducted, so far as possible, in the same manner and with like effect as if a voluntary petition for adjudication for bankruptcy had been filed and (Section 378(2))—

a decree of adjudication had been entered *on the day when the petition under this chapter was filed*; * * * (Italics supplied.)

Further, in this connection, Section 302 of the Bankruptcy Act provides:

The provisions of chapters I to VII, inclusive, of this Act shall, insofar as they are not inconsistent with or in conflict with the provisions of this chapter, apply in proceedings under this chapter. For the purposes of such application, provisions relating to “bankrupts” shall be deemed to relate also to “debtors,” and “bankruptcy proceedings” or “proceedings in bankruptcy” shall be deemed to include proceedings under this chapter. For the purposes of such application the date of the filing of the petition in bankruptcy shall be taken to be the date of the filing of an original petition under section 322 of this Act, and the date of adjudication shall be taken to be the date of the filing of the petition under section 321 or 322 of this Act except where an adjudication had previously been entered.

The pertinency of these statutory provisions to the instant record finds apt expression in the opinion of the Court of Appeals for the Second Circuit in the *Rassner* case, where they were equally applicable, as follows (pp. 705-706):

When the petition was filed and the debtor continued operation, it acted as an officer of the bank-

ruptcy court. Bankruptcy Act, §§342, 343, 11 U. S. C. A. §§742, 743. It was subject "at all times to the control of the court." §342. And in operating the business it had to have "authorization by and subject to the control of the court." *When the debtor was displaced by the bankruptcy trustee, there was no break in the continuity in relationship, for the order of adjudication related back and the original petition for an arrangement became the vital date.* Bankruptcy Act, §302, 11 U. S. C. A., §702; cf. *Lockhart v. Garden City Bank & Trust Co.*, 2 Cir., 116 F. 2d 658, 660. The trustee in bankruptcy, so far as outsiders are concerned, must proceed subject to any claims available against the debtor in possession. (Italics supplied.)

C. No Question of Tracing Trust Property Is Involved, Since the Bankruptcy Court, as a Court of Equity, Will Direct Its Officers in Administering This Estate, in Its Judicial Custody and Under Its Control, to Comply With Equitable Obligations Imposed by Law.

The cases cited by the District Court [R. 80], namely, *In re Independent Automobile Forwarding Corp.*, 118 F. 2d 537, 539 (C. A. 2d), reversed on other grounds, *sub nom.*, *United States v. New York*, 315 U. S. 510; and *In re Frank*, 25 Fed. Supp. 1005 (S. D. N. Y.),² involve tracing trust property before bankruptcy, and, as the *Rassner* case holds (pp. 705-706), have no application where

²Significantly, these cases cited by the court below were also cited by the District Court for the Eastern District of New York, whose decision the Court of Appeals for the Second Circuit reversed in the *Rassner* case. *In re New Bedford Rest.* 40 Fed. Supp. 288, 290. Again, the Court of Appeals for the Second Circuit, in the *Rassner* case, obviously considered them inapplicable, although one of the cited cases was its own prior decision and the other was a decision of a District Court in the Second Circuit.

the trust obligation is imposed *during court custody* subsequent to bankruptcy. Courts of bankruptcy are courts of equity and in the administration of bankrupt estates exercise their powers as courts of equity. *Pepper v. Litton*, 308 U. S. 295, 303-304. As discussed, *supra*, in subpoint B, there has been no break in the continuity of relationship of the equity court to this estate from the date of the filing of the petition for Arrangement through bankruptcy adjudication up to the present time. As the court officer, the debtor in possession, neglected to fulfill the obligation in equity, imposed by statute, the bankruptcy court as a court of equity will do equity and in administering the estate will see to it that its succeeding officer, the bankruptcy trustee complies with the obligation imposed by Congress. Where in violation of Section 3661 of the Internal Revenue Code these officers fail to segregate the amount of taxes withheld, the equity court will direct the performance of this equitable obligation and the distribution of the trust fund to the beneficiary, the United States. Such is the precise reasoning and the holding of the *Rassner* case with respect to a similar statutory trust recognized there in favor of the City of New York, as follows (p. 706):

If a debtor in possession failed to segregate the taxes collected from vendees, it did so under the control of the court. * * * If we hold that the city must now trace the funds, we state in effect that any beneficiary of a trust which is handled by an officer of a bankruptcy court must always protect himself by petitioning in advance for proper administration of the trust. Thus stated, it can be seen that we would be condoning improper action by a trustee so long as he could successfully get away with it. As a court of equity, a bankruptcy court can hardly pro-

ceed on this assumption. It is the duty of the bankruptcy court in distributing an estate to do so equitably.

Surely, as the *Rassner* opinion further declared (p. 706):

Protection of a beneficiary of a trust whose funds have been misappropriated is a proper part of equitable administration.

In application of this principle, where trust funds are diverted by an officer of the court for use in the administration of the estate in court custody, preferential payment is accorded the trust claimant even in cases where he is unable to trace to the point of distribution.

In *Ex parte Simmonds*, 16 Q. B. D. 308 (Ct. of Appeal), the trustee in bankruptcy applied funds, received under a mistake of law, to the payment of dividends to creditors. The court later ordered the funds repaid to the person from whom they were received, out of monies later coming into the hands of the trustee. In so doing, the court, by Cotton, L. J., said (p. 314):

But, in my opinion, we must regard the funds available for distribution among the creditors under a bankruptcy or liquidation as one entire fund, and, if that fund has been erroneously increased, * * * out of any moneys which may hereafter be in the hands of the trustee and applicable to the payment of dividends to the creditors, the amount which has come into his hand by mistake ought to be repaid.

In *Standard Oil Co. v. Hawkins*, 74 Fed. 395 (C. A. 7th), a receiver appointed by the court paid out trust funds in the administration of the receivership. In giving the trust claimant a preference, notwithstanding his

inability to trace, the court uttered language which sharply points to the distinction between the case involving misappropriation by an individual and the case, like the instant one, of misappropriation by a court officer. The court there said (p. 402):

Here the receiver is an officer of the law, having the assets in *custodia legis*. He has no interest in the fund, save to see that it shall be distributed among those entitled to it according to the highest principles of honesty and of equity. The assets of the bank received by him are, with respect to the question in hand, to be treated as an entirety. Those assets have been swelled by the property of the appellant wrongfully obtained by the bank, and which went into the possession of the receivers. That in the payment of dividends he has disbursed the actual money so received can make no difference, so long as assets remain out of which restitution can be made. The creditors have received that to which they were not entitled, and that which belonged to the appellant. If restitution be made out of the assets still remaining, the creditors will receive no less than that to which they were originally entitled, and the appellant will only receive that which was its due. To compass such a result is the highest equity, since otherwise the appellant will be deprived of its own, and the general creditors will receive that to which they have no right.

More recently, in *Hood v. Hardesty*, 94 F. 2d 26 (C. A. 4th), certiorari denied, 303 U. S. 661, the court permitted a trust claimant to recover in full the amount of untraceable trust monies, misapplied by the receiver of a state bank in the administration of the latter's receiver-

ship. The language of the court in that case strongly supports the point urged here, as follows (p. 29):

On the third question, no case is presented for application of the doctrine of tracing trust funds. Defendant in his official capacity has received, from the proceeds of the bonds improperly pledged, funds to which he is not legally entitled. These may have been disbursed to general creditors; but he now has on hand other funds from which restitution can be made without injustice to any one. It is well settled that in such case a court of equity will direct restitution.

See also to the same effect *In re Kenney & Greenwood*, 23 F. 2d 681 (Me.); *Shipe v. Consumers' Service Co.*, 28 F. 2d 53 (Ind.).

In the *Rassner* case, at the time the bankruptcy trustee was appointed as court officer in charge of the estate succeeding to the debtor in possession, he received only \$7.50 in cash and subsequently the greater part of the money realized was made possible only because of the trustee's activities in invalidating certain mortgages covering chattels. (P. 705.) Here, as shown in Point I, *supra*, the estate has at all times been in possession of assets amply sufficient to satisfy the Government's trust claim (even though not in cash) from which the tax may be realized and paid. Moreover, even though the amount of the tax was not segregated as required by Section 3661, the assets of the estate have been augmented by the sums which would otherwise have been paid to the wage-earners and which were withheld from their salaries. Thus, plainly no sound distinction can be taken between the instant case and the *Rassner* case on the

ground that taxes were “collected” in the *Rassner* case, while they are “withheld” here. Section 3661 of the Code impresses a trust equally upon taxes “withheld” with those “collected” and there were ample assets in the instant estate to satisfy the withholding. Again, the *Rassner* case proceeds on the hypothesis that the “collected” taxes there were never segregated and they could not be traced into the bankruptcy trustee’s possession.

Equity regards that as done which ought to be done. Hence, the court below should have directed an amount out of the assets in its custody, equivalent to the amount withheld from wages by the debtor in possession, to be paid over to the Government. As between administration creditors and the United States, it is submitted the equities are balanced in favor of the United States. If this Court sustains the United States, these creditors will not receive less than they would have, if the court officer in the Arrangement had complied with the statute and carried out the trust imposed. Under the decision below the creditors would be allowed to profit from a flaunting of the statute in the course of judicial administration of an estate in court custody. Again, as a consequence of withholding of tax amounts from wages, the United States has suffered a change of position since the taxes against the wage-earners by virtue of the withholding are conclusively regarded as paid. See subpoint A, *supra*.

Moreover, the sanction of severe criminal penalties ordinarily is available to insure compliance with the provisions of Section 3661. See Section 2707 of the Internal Revenue Code, made applicable to the instant taxes by Sections 1430 and 1627, the last paragraphs of Section 402.304, Treasury Regulations 106 (Appendix, *infra*), and Section 405.301 of Treasury Regulations 116 (Ap-

pendix, *infra*). Yet, as held with respect to analogous criminal penalties in the *Rassner* case (p. 706):

The city could hardly seek fine or imprisonment of the debtor or its officers for failure to segregate funds—assuming the penal provisions, Administrative Code, c. 41, Tit. N, §41-17.0, as amended by Local Laws 1940, p. 362, go that far—because the status of the debtor as under court control would be a defense. The most that the city could seek would be a court order directing the debtor in possession to keep sales tax receipts separate from the ordinary transactions of the business, in other words, to obey the sales tax law. If we hold that the city must now trace the funds, we state in effect that any beneficiary of a trust which is handled by an officer of a bankruptcy court must always protect himself by petitioning in advance for proper administration of the trust. Thus stated, it can be seen that we would be condoning improper action by a trustee so long as he could successfully get away with it.

To hold the debtor in possession failed to segregate the taxes is to say the equity court failed to do so and there is no sanction against the court.

Even if the debtor in possession and its officers do not possess complete criminal immunity, surely the court of equity will not countenance administration of a fund under its control to be carried on in such a manner as to involve violation of penal laws by court officers.³

³The officer of the court during the Arrangement was, of course, the debtor in possession. While the United States may have claims under the bond given by H. B. Kelley, who was appointed disbursing officer on behalf of the debtor in possession, such possible rights of action against the surety and others constitute additional remedies [R. 22-23, 29-30, 76-78], and do not derogate in any way from the contentions made here based on violations by the court officer itself, namely, the debtor corporation.

III.

In Any Event, the Trust Fund Can Here Be Traced
into the Bankrupt Estate.

As set forth in the preceding Point II, in view of the uninterrupted administration and control by the equity court and its officers of the instant estate during the time when the taxes were withheld and the trust impressed under Section 3661 of the Internal Revenue Code, the tracing of a trust *res* in the premises is unnecessary. However, if this Court does not agree with the contention advanced in Point II, *supra*, or with the *Rassner* case, it is additionally argued in this Point III that the amount withheld can be shown to have augmented and can be followed into the bankrupt estate. As appears from the legislative history of Section 3661 discussed in Point II, subpoint A, *supra*, the congressional purpose was immediately to impress the amount of taxes withheld with the trust in favor of the United States, and to transform the debt obligation existing under the prior law into a trust obligation. Thus, the instant equitable interest imposed by law is markedly in contrast with the creditor-debtor relation present in *McKee v. Paradise*, 299 U. S. 119, 122-123. There, by agreement merely a debt obligation arose; here, on the other hand, Congress intentionally imposed a trust obligation and the instant record presents circumstances (*McKee v. Paradise, supra*, p. 122), "in which equity will fasten a constructive trust upon property in order to frustrate a violation of fiduciary duty."

The amount withheld never became part of the bankrupt estate. Like the sale tax involved in *In re Goldberger, Inc.*, 32 Fed. Supp. 615, 616 (E. D. N. Y.):

It should have been set aside and kept separate for the account of the City of New York. At no time did

this sum become a part of the estate of the bankrupt for general distribution. This amount must be paid to the City of New York before the payment of the expenses of administration, not because of priority, but due to the fact that the debtor was only the trustee of the money collected, its never becoming a part of the estate.

As discussed in Point I, *supra*, at the time the taxes were withheld, there were adequate assets in the estate (even if not in cash) to cover the trust fund. The real estate and chattels, for example, the proceeds of which the record demonstrates are in the trustee's possession, formed part of the estate at the time the fiduciary duty arose and the trust imposed and have at all times remained in the estate. As the Supreme Court of California recently held in *Garrison v. Edward Brown & Sons*, 25 Cal. 2d 473, 480, citing numerous cases:

It is settled as to both express trusts and trusts created by operation of law that an ascertainable interest in a bank account of the trustee in which funds of the trustee and of the beneficiary are deposited constitutes an asset definite enough to be the subject matter of a trust.

The same rule, which the cited case applies to an ascertainable interest in the bank account of the trustee, should apply equally to an ascertainable interest in other estate assets. The assets, which are in the hands of the court, have been directly added to and benefited by an amount of money withheld by the debtor in possession from the wages of employees. Despite estate losses during operation by the debtor in possession, the lowest intermediate amount clearly never was less than the sum due the United States. Under such circumstances the burden or

“laboring oar” falls upon the appellee to show dissipation of the equitable interest belonging to the United States. As this Court held in *Scully v. Pacific States Savings & Loan Co.*, 88 F. 2d 384, 387, certiorari denied, 301 U. S. 704:

The cash items being shown to be in the trust fund, the lien must be impressed, unless appellant, who has the laboring oar, has shown a dissipation of the trust fund.

And see numerous authorities listed in note 2 of the cited case.

Conclusion.

For the reasons above given, the order of the District Court is erroneous and should be reversed.

Respectfully submitted,

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APPENDIX.

Bankruptcy Act, c. 541, 30 Stat. 544:

SEC. 342 [as added by the Act of June 22, 1938, c. 575, 52 Stat. 840, 909]. Where no receiver or trustee is appointed, the debtor shall continue in possession of his propetry [*sic*] and shall have all the title and exercise all the powers of a trustee appointed under this Act, subject, however, at all times to the control of the court and to such limitations, restrictions, terms, and conditions as the court may from time to time prescribe.

(11 U. S. C. 1946 ed., Sec. 742.)

SEC. 343 [as added by the Act of June 22, 1938, *supra*]. The receiver or trustee, or the debtor in possession, shall have the power, upon authorization by and subject to the control of the court, to operate the business and manage the property of the debtor during such period, limited or indefinite, as the court may from time to time fix, and during such operation or management shall file reports thereof with the court at such intervals as the court may designate.

(11 U. S. C. 1946 ed., Sec. 743.)

Internal Revenue Code:

SEC. 1401. DEDUCTION OF TAX FROM WAGES.

(a) *Requirement.*—The tax imposed by section 1400 shall be collected by the employer of the taxpayer, by deducting the amount of the tax from the wages as and when paid.

* * * * *

(26 U. S. C. 1946 ed., Sec. 1401.)

SEC. 1622. [As added by the Current Tax Payment Act of 1943, c. 120, 57 Stat. 126, Sec. 2.] INCOME

TAX COLLECTED AT SOURCE.

(a) [as amended by Revenue Act of 1948, c. 168, 62 Stat. 110, Sec. 501] *Requirement of Withholding*.—Every employer making payment of wages shall deduct and withhold upon such wages a tax equal to 15 per centum of the amount by which the wages exceed the number of withholding exemptions claimed multiplied by the amount of one such exemption as shown in subsection (b) (1).

* * * * *

(26 U. S. C. 1946 ed., Sec. 1622.)

SEC. 3661. ENFORCEMENT OF LIABILITY FOR TAXES COLLECTED.

Whenever any person is required to collect or withhold any internal-revenue tax from any other person and to pay such tax over to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such funds shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.

(26 U. S. C. 1946 ed., Sec. 3661.)

Treasury Regulations 106, promulgated under the Internal Revenue Code:

SEC. 402.304. *Collection of, and liability for, employees' tax.*—The employer shall collect from each of his employees the employees' tax with respect to wages for employment performed for the employer by the employee. The employer shall make the collection by deducting or causing to be deducted the amount of the employees' tax from such wages as and when paid, either actually or constructively. The employer is required to collect the tax, notwithstanding the wages are paid in something other than money (for example, wages paid in stock, board, lodging; see section 402.227) and to pay the tax to the collector in money. In collecting employees' tax, the employer shall disregard any fractional part of a cent of such tax unless it amounts to one-half cent or more, in which case it shall be increased to 1 cent. The employer is liable for the employees' tax with respect to all wages paid by him to each of his employees whether or not it is collected from the employee. If, for example, the employer deducts less than the correct amount of tax, or if he fails to deduct any part of the tax, he is nevertheless liable for the correct amount of the tax. Until collected from him the employee is also liable for the employees' tax with respect to all the wages received by him. Any employees' tax collected by or on behalf of an employer is a special fund in trust for the United States. The employer is indemnified against the claims and demands of any person for the amount of any payment of such tax made by the employer to the collector.

Section 2707 of the Internal Revenue Code (see page 87 of these regulations) provides severe penalties for a willful failure to pay, collect, or truthfully account for and pay over, the employees' tax or for a willful attempt in any manner to evade or defeat the tax. Such penalties may be incurred by any person, including the employer, and any officer or employee of a corporate employer, or member or employee of any other employer, who as such employer, officer, employee, or member is under a duty to perform the act in respect of which the violation occurs.

Treasury Regulations 116, promulgated under the Internal Revenue Code:

SEC. 405.301. *Liability for Tax.*—The employer is required to collect the tax by deducting and withholding the amount thereof from the employee's wages as and when paid, either actually or constructively. As to when wages are constructively paid, see section 405.1. An employer is required to deduct and withhold the tax notwithstanding the wages are paid in something other than money (for example, wages paid in stocks or bonds; see section 405.101) and to pay the tax to the collector or duly designated depository of the United States, as the case may be, in money. If wages are paid in property other than money, the employer should make necessary arrangements to insure that the amount of the tax required to be withheld is available for payment to the collector.

Every person required to deduct and withhold the tax under section 1622 from the wages of an employee is liable for the payment of such tax whether or not it is collected from the employee. If, for example, the employer deducts less than the correct amount of tax, or if he fails to deduct any part of the tax, he is nevertheless liable for the correct amount of the tax. However, if the employer in violation of the provisions of section 1622 fails to deduct and withhold the tax, and thereafter the income tax against which the tax under section 1622 may be credited is paid, the tax under section 1622 shall not be collected from the employer. Such payment does not, however, operate to relieve the employer from liability for penalties or additions to the tax for failure to deduct and withhold within the time prescribed by law or regulations made in pursuance of law. The employer will not be relieved of his liability for payment of the tax required to be withheld unless he can show that the tax against which the tax under section 1622 may be credited has been paid.

The amount of any tax withheld and collected by the employer is a special fund in trust for the United States.

The employer or other person required to deduct and withhold the tax under section 1622 is relieved of liability to any other person for the amount of any such tax withheld and paid to the collector or

deposited with a duly designated depository of the United States.

Section 2707 provides severe penalties for a willful failure to pay, collect, or truthfully account for and pay over, the tax imposed by section 1622, or for a willful attempt in any manner to evade or defeat the tax. Such penalties may be incurred by any person, including the employer, and any officer or employee of a corporate employer, or member or employee of any other employer, who as such employer, officer, employee, or member is under a duty to perform the act in respect of which the violation occurs.